

**Controls Over the Identification and Selection
of Foreign Controlled Corporations for
Examination Need Improvement**

July 2001

Reference Number: 2001-30-119

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

July 30, 2001

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS
DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Controls Over the Identification and
Selection of Foreign Controlled Corporations for Examination
Need Improvement

This report presents the results of our review of whether the processes in the Internal Revenue Service's (IRS) Large and Mid-Size Business (LMSB) Division effectively address the compliance of Foreign Controlled Corporations (FCC). In summary, the LMSB Division's processes for research and planning, as well as controls over FCC tax returns selected for examination by International Examiner revenue agents, need improvement. Effective research and planning necessitates access to accurate and timely information from the Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472). These returns have not been timely processed for use. In addition, referral controls need to be improved to ensure that all FCC returns selected for examination by international classifiers are timely referred to the International Examination groups by the Domestic revenue agents. Overall, we were not able to determine whether the IRS has an effective process to ensure the compliance of FCCs.

In commenting on a draft of the report, the Commissioner, LMSB Division, agreed with our findings and recommendation. He also noted other actions that are underway to more effectively address the compliance of FCCs. We have incorporated the comments into the report where appropriate, and the complete response to the draft report is included as an appendix.

Copies of this report are also being sent to IRS officials who are affected by the recommendation. Please contact me at (202) 622-6510 if you have any questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs) at (202) 622-3837.

**Controls Over the Identification and Selection of Foreign Controlled
Corporations for Examination Need Improvement**

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Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement

Executive Summary

The Internal Revenue Service's (IRS) Large and Mid-Size Business (LMSB) Division serves approximately 224,000 business taxpayers with assets of more than \$5 million. These taxpayers make annual cash payments of \$712 billion. The LMSB Division annually examines 20,000 returns, including 450 to 575 of the nation's largest corporations. Part of the Division's mission is to be a world class organization, responsive to the needs of business taxpayers in a global environment, while applying innovative approaches to customer service and compliance.

One of the LMSB Division's four strategic initiatives to meet its mission is to build a tax administration to effectively deal with globalization. The LMSB Division is responsible for identifying, screening, and determining whether returns with international features require examination, for both the LMSB and the Small Business/Self-Employed (SB/SE) Divisions.

The Foreign Controlled Corporation (FCC), also referred to as a foreign controlled domestic corporation, is part of the globalization that the LMSB Division must address. Potential FCCs comprised 65,726 returns (3 percent) of the approximately 2.2 million corporation¹ returns filed in the United States (U.S.) for Tax Year (TY) 1997. An FCC is a corporation incorporated in the U.S. that is controlled by a foreign entity or entities, directly or indirectly. Control is defined as the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock.² The IRS identifies corporations with 25 percent or greater foreign ownership as potential FCCs for internal processing.

Our objective was to determine whether the LMSB Division's processes effectively address the compliance of FCCs.

Results

The LMSB Division's processes for research and planning, as well as controls over FCC returns selected for examination by International Examiner revenue agents, need improvement. Effective research and planning necessitates access to accurate and timely information from the Information Return of a 25% Foreign-Owned U.S. Corporation or a

¹ This does not include S Corporations, Life Insurance Companies, Foreign Corporations, Property and Casualty Insurance Companies, Real Estate Investment Trusts, or Regulated Investment Companies.

² Internal Revenue Code (I.R.C.) § 304(c) (1998).

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Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472).³ These returns have not been timely processed for use. In addition, referral controls need to be improved to ensure that all FCC returns selected for examination by international classifiers are timely referred to the International Examination groups by the Domestic revenue agents. Overall, we were not able to determine whether the IRS has an effective process to ensure the compliance of FCCs.

Foreign Ownership Return Information Is Not Processed Timely, Limiting Its Effective Use in Research and Planning Activities

Form 5472 is required to be filed in duplicate by the reporting corporation. The reporting corporation files one or more copies of the Form 5472 separately with the Philadelphia Submission Processing Center (PSPC). The reporting corporation is also required to attach one or more copies of Form 5472 to the corporate income tax return that it files. The PSPC annually received approximately 95,000 Form 5472 returns for TYs 1996 to 1999. However, due to insufficient resources, the PSPC processed none of the TY 1996 and 1997 returns, while timely processing 100 percent of the TY 1998 returns and 65 percent of the TY 1999 returns into the Foreign Information System (FIS). The IRS' ability to perform research, identify trends, and estimate the effect of transfer pricing issues related to foreign-owned U.S. corporations and foreign corporations engaged in a U.S. trade or business depends on the availability of timely and complete FIS data. In December 2000, the LMSB Division provided additional resources to process the Forms 5472.

Returns with International Features Are Not Always Referred to International Examination Groups Prior to Decisions Not to Examine

All corporate returns with 25 percent or more foreign ownership are identified during returns processing in each of the IRS' submission processing centers. These returns are forwarded to a unit to await screening for examination potential. Periodically, the LMSB Division sends a team of International Examiners to each of the submission processing centers to screen these returns. The returns selected are marked for referral to an International Examination group. The selected returns are then forwarded to Domestic Examination groups in the LMSB and the SB/SE Divisions for further evaluation.

Controls to ensure these selected returns are actually referred by Domestic Examination groups to International Examination groups are currently not required. Our survey of four submission processing centers showed only one had established a computer code to prevent returns from being closed without a referral to an International Examination group.

³ I.R.C. § 6038A(b) (1996) and Treas. Reg. § 1.6038A-2(a)(1).

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Summary of Recommendation

The Commissioner, LMSB Division, in consultation with the Commissioner, SB/SE Division, should establish a uniform control to prevent local Domestic Examination groups from making a decision not to examine a selected return with international features without the concurrence an International Examination group. This can be done by establishing a computer freeze code at the submission processing centers on the selected returns that can be released only by the International Examination groups once the return has been referred.

Management's Response: The LMSB Division formed an International Classification Task Force that has been looking at the non-referral problem and is considering various options to ensure timely referrals by domestic examiners to international groups. Until the task force completes its work, the LMSB Division will emphasize using the freeze code to prevent domestic examiners from prematurely closing cases they should refer to the International Examination groups. In addition, managers in the LMSB and SB/SE Divisions will coordinate closer to ensure timely referrals of international cases and the use of an interim freeze code. Management's complete response to the draft report is included as Appendix IV.

Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement

Objective and Scope

Our objective was to determine whether the LMSB Division's processes effectively address the compliance of FCCs.

Our objective was to determine whether the Large and Mid-Size Business (LMSB) Division's processes effectively address the compliance of Foreign Controlled Corporations (FCCs). Our audit tests focused on evaluating:

- The process of identifying, screening, and selecting FCC returns for additional evaluation and examination.
- The controls over FCC returns selected during screening to ensure that they received additional evaluation.
- The effect of FCC information returns not being processed timely.

The audit was performed in accordance with *Government Auditing Standards* between November 2000 and March 2001. On-site tests were performed in the IRS National Headquarters, the LMSB Division National Headquarters, the Ogden Submission Processing Center, the Philadelphia Submission Processing Center (PSPC), and LMSB Division groups in the metropolitan Los Angeles area. In addition, we surveyed managers in Examination Classification units in the Brookhaven Submission Processing Center, the Cincinnati Submission Processing Center, and the PSPC.

Details of our objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The Internal Revenue Service's (IRS) LMSB Division serves approximately 224,000 business taxpayers with assets of more than \$5 million. These taxpayers make

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The 65,726 potential FCCs are part of the globalization of the economy that the LMSB Division must address.

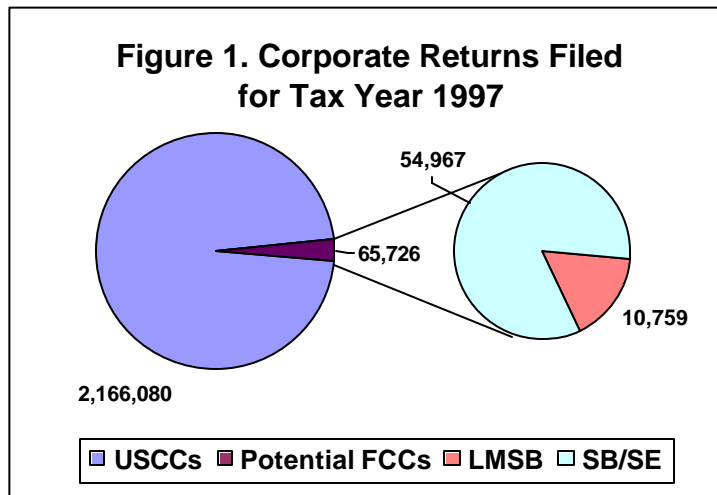
annual cash payments of \$712 billion. The LMSB Division annually examines 20,000 returns, including 450 to 575 of the nation's largest corporations. Part of the Division's mission is to be a world class organization, responsive to the needs of business taxpayers in a global environment, while applying innovative approaches to customer service and compliance.

One of the LMSB Division's four strategic initiatives to meet its mission is to build a tax administration to effectively deal with globalization. The LMSB Division is responsible for identifying, screening, and determining whether returns with international features require examination, for both the LMSB and the Small Business/Self-Employed (SB/SE) Divisions.

The FCC, also referred to as a foreign controlled domestic corporation, is part of the globalization of the economy that the LMSB Division must address. Potential FCCs comprised 65,726 returns (3 percent) of the approximately 2.2 million corporation¹ returns filed in the U.S. for Tax Year (TY) 1997. The LMSB Division has jurisdiction for 10,759 of these returns, and the remaining 54,967 returns come under the jurisdiction of the SB/SE Division (see Figure 1).

¹ This does not include S Corporations, Life Insurance Companies, Foreign Corporations, Property and Casualty Insurance Companies, Real Estate Investment Trusts, or Regulated Investment Companies.

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Source: IRS Statistics of Income Division.

An FCC is a corporation incorporated in the U.S. that is controlled by a foreign entity or entities, directly or indirectly. Control is defined as the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock.² The IRS identifies corporations with 25 percent or greater foreign ownership as potential FCCs for internal processing.

Results

We were unable to determine whether the IRS has an effective process to ensure the compliance of FCCs, due to control weaknesses.

The LMSB Division's processes for research and planning, as well as controls over FCC returns selected for examination by International Examiner revenue agents, need improvement. Effective research and planning necessitates access to accurate and timely information from the Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

² Internal Revenue Code (I.R.C.) § 304(c) (1998).

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(Form 5472).³ These returns have not been timely processed for use. In addition, referral controls need to be improved to ensure that all FCC returns selected for examination by international classifiers are timely referred to the International Examination groups by the Domestic revenue agents. Overall, we were not able to determine whether the IRS has an effective process to ensure the compliance of FCCs.

Foreign Ownership Return Information Is Not Processed Timely, Limiting Its Effective Use in Research and Planning Activities

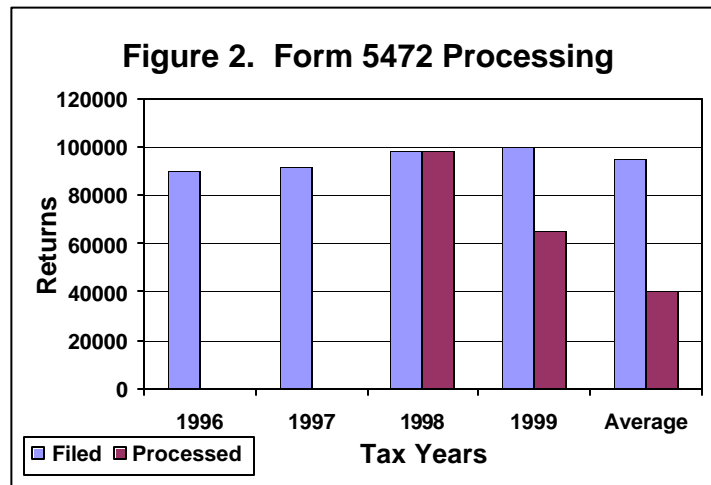
Form 5472 is required to be filed in duplicate by the reporting corporation if it is 25 percent foreign owned, directly or indirectly, and has monetary or non-monetary transactions between itself and a foreign related party. The reporting corporation files one or more copies of the Form 5472 separately with the PSPC. The reporting corporation is also required to attach one or more copies of Form 5472 to the corporate income tax return that it files.

The PSPC annually received approximately 95,000 Form 5472 returns for TYs 1996 to 1999. However, it timely processed none of the TY 1996 and 1997 returns, 100 percent of the TY 1998 returns, and 65 percent of the TY 1999 returns into the FIS.

The PSPC annually received approximately 95,000 Form 5472 returns for TYs 1996 to 1999. However, due to insufficient resources, the PSPC processed none of the TY 1996 and 1997 returns, while timely processing 100 percent of the TY 1998 returns and 65 percent of the TY 1999 returns into the Foreign Information System (FIS). Figure 2 illustrates both the growing volume and inconsistent processing of the Forms 5472.

³ I.R.C. § 6038A(b) (1996) and Treas. Reg. § 1.6038A-2(a)(1).

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Source: Agreement between LMSB, SB/SE, and Wage and Investment Divisions signed December 21, 2000.

Information transcribed into the FIS is used for research and analysis of transactions between U.S. and foreign entities.

The PSPC had only 22 FTEs available to process information into the FIS until December 2000, when it received an additional 70.4 FTEs.

Information processed into the FIS comes from the Form 5472 and the Information Return of U.S. Persons With Respect To Certain Foreign Corporations (Form 5471).⁴ The information transcribed into the FIS is used for research and analysis of transactions between U.S. and foreign entities. In addition, it is being used to develop a computerized screening tool to identify potential international issues on tax returns.

The PSPC was unable to process the Forms 5472 timely due to insufficient resources. From 1996 to December 2000, the PSPC devoted approximately 22 Full Time Equivalents (FTE)⁵ to processing information into the FIS. On December 21, 2000, a Memorandum of Understanding (MOU) was executed between the LMSB Division and the Wage and Investment (W&I) Division. The terms of the MOU call for the LMSB Division to provide the PSPC with an additional \$2.6 million for 70.4 FTEs to process the

⁴ Internal Revenue Manual (IRM) 3.29.253, Foreign Information System.

⁵ An FTE generally includes 260 compensable days, or 2,080 hours.

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Untimely processing of Forms 5472 into the FIS impedes the IRS' ability to identify trends and estimate the effect of transfer pricing issues related to foreign-owned U.S. corporations and foreign corporations engaged in a U.S. trade or business.

backlog of 180,000 Forms 5471 and 217,000 Forms 5472 into the FIS, as well as keep current with the TY 2000 filings.

The IRS' ability to perform research, identify trends, and estimate the effect of transfer pricing issues related to foreign-owned U.S. corporations and foreign corporations engaged in a U.S. trade or business depends on the availability of timely and complete FIS data. Untimely input of these data to FIS impedes the IRS' ability to accomplish this.

Since the FIS database was not complete during our review, we were unable to identify the universe of potential FCC returns. This prevented us from conducting a detailed analysis of the effectiveness of IRS actions to ensure FCC compliance.

In his July 11, 2001, response to our draft report, the Commissioner, LMSB Division, stated that there had been continued progress in reducing the backlog of Forms 5471 to 90,000 returns, and of Forms 5472 to 70,000 returns. The elimination of the entire backlog is planned by December 31, 2001.

Returns with International Features Are Not Always Referred to International Examination Groups Prior to Decisions Not to Examine

All corporate returns with 25 percent or more foreign ownership are identified during returns processing in each of the IRS' submission processing centers. These returns are forwarded to a unit to await screening for examination potential. Periodically, the LMSB Division sends a team of International Examiners to each of the submission processing centers to screen these returns. The returns selected are marked for referral to an International Examination group. The selected returns are then forwarded to Domestic Examination groups in the LMSB and SB/SE Divisions for further evaluation.

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One submission processing center established a computer code to prevent returns from being closed from the AIMS without referral to an International Examination group.

The IRM requires that a potential FCC return be referred to an International Examination group prior to a decision not to examine.

Controls to ensure these selected returns are actually referred by the Domestic Examination groups to International Examination groups are currently not required. Our survey of four submission processing centers showed only one had established a computer code to prevent returns from being closed from the Audit Information Management System (AIMS) without a referral to an International Examination group.

Currently there is no requirement in the IRM to establish a computer code to prevent Domestic Examination groups from closing out returns marked for referral to International Examination groups prior to referral being made. However, the IRM specifies that before a decision is made to not examine a domestic return that is 25 percent or more foreign-owned, the return must be referred to an International Examination group.⁶ The IRM also requires the Key District Program Manager to approve the examination evaluation of a return with international issues and make the decision not to examine it. Since the IRS reorganization, the duties of the Key District Program Manager position have been misunderstood by examination groups in local offices and the individuals who have this delegated authority. The LMSB Division has efforts underway to clarify the duties and authority.

The General Accounting Office's (GAO) *Standards for Internal Control in the Federal Government* specify that control activities are the policies, procedures, techniques and mechanisms that enforce management's directives. They help ensure that actions are taken to address risks. Control activities are an integral part of an entity's planning, implementing, reviewing, and accountability for stewardship of government resources and achieving effective results.

⁶ IRM Chapter 4.2 Section 4.2.2.5.7, Surveying Returns With International Issues.

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Domestic managers and revenue agents may be reluctant to make referrals because it may lengthen cycle time.

Our discussions with International Examination personnel indicated that they believed Domestic Examination group managers and agents are reluctant to refer returns to International Examination groups because it may lengthen cycle time.⁷ One International Examination group manager expressed the following opinion:

For years now there has been tremendous concern about opening and closing cases as quickly as possible. The perception in the field is that referrals for support (be it International, Financial Products, etc.) will cause a case to be open longer and thus there has not been any encouragement to make these referrals. I have seen and noted too many instances where a group hold [sic] onto a case with significant international potential and then survey [sic] it shortly before the statute will expire so that we had no opportunity to try and get it worked.

To determine what the effect of the control weakness was, we randomly selected from the Final Fiscal Year (FY) 1999 Non-Examined AIMS database a nationwide sample of 60 FCC returns where a decision not to examine had been made. The review showed that:

- Thirteen (22 percent) returns were identified for referral to an International Examination group, but 6 (46 percent) of these 13 returns had not been referred prior to the decision not to examine.
- Forty (67 percent) returns required no International Examination group action.
- Seven (12 percent)⁸ returns were unavailable for review.

⁷ Cycle time is the time period between the examination start date and the examination disposal (closing) date measured in days.

⁸ These percentages sum to 101 percent due to rounding.

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Six of the 13 returns marked for referral to an International Examination unit had not been referred prior to the decision not to examine, and 5 of these returns had potential international tax issues ranging from \$2 million to \$548 million.

We obtained the assistance of an International Examiner revenue agent from an LMSB Division Examination team to review the six returns that had not been referred to an International Examination unit prior to the decision not to examine. The agent identified significant issues on five of six returns that warranted examination in the areas of transfer pricing, inter-company loans, and foreign tax credits. The agent identified potential transfer pricing issues based on amounts reported of \$893 million on 3 returns, ranging from \$20 million to \$548 million. The agent also identified inter-company loan issues based on amounts reported of \$283 million on 4 returns, ranging from \$2.6 million to \$250 million, and 1 foreign tax credit issued based on the \$2 million reported.

The LMSB Division spends significant resources to process, identify, screen, and select FCCs and other returns with international features for examination. However, there is potential for significant issues to be improperly excluded from examination due to an internal control weakness.

Recommendation

1. The Commissioner, LMSB Division, in consultation with the Commissioner, SB/SE Division, should establish a uniform control at the submission processing centers over returns screened and selected by International Examiners for mandatory referral. The control should prevent the local Domestic Examination group from making a decision not to examine a selected return without the concurrence of an International Examination group. This can be done by establishing a computer freeze code at the submission processing centers on the selected returns that can be released only by International Examination groups once the return has been referred.

Management's Response: The Commissioner, LMSB Division, agreed with the recommendation. The LMSB Division formed an International Classification Task

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Force that has been looking at the non-referral problem and is considering various options to ensure timely referrals by Domestic revenue agents to International Examination groups. Until the task force completes its work, the LMSB Division will emphasize using the freeze code to prevent Domestic revenue agents from prematurely closing cases they should refer to the International Examination groups. In addition, managers in the LMSB and SB/SE Divisions will coordinate closer to ensure timely referrals of international cases and the use of an interim freeze code.

Conclusion

We were unable to determine whether the IRS and the LMSB Division have an effective process to address the compliance of FCCs, due to the control problems identified in this report. Correcting these two control activities will help the LMSB Division effectively address the compliance of FCCs by identifying all the FCC returns on a timely basis and ensuring that the returns with international features selected for additional evaluation and potential examination are referred to the International Examination function.

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Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to determine whether the Large and Mid-Size Business (LMSB) Division's processes effectively address the compliance of Foreign Controlled Corporations (FCCs). On-site tests were performed in the Internal Revenue Service's (IRS) National Headquarters, the LMSB Division's National Headquarters, the Ogden Submission Processing Center (OSPC), the Philadelphia Submission Processing Center (PSPC), and LMSB Division groups in the metropolitan Los Angeles area. In addition, we surveyed managers in examination classification units in the Brookhaven Submission Processing Center (BSPC), the Cincinnati Submission Processing Center (CSPC), and the PSPC. The specific audit tests included the following:

- I. Determined the potential effect to corporate tax receipts and additional assessments made upon the examination of FCC returns with assets of \$5 million or more in comparison with United States Controlled Corporations with assets of \$5 million or more. We were unable to complete this sub-objective because it was impossible to accurately identify all the FCC returns on the closed Audit Information Management System (AIMS) database by linking it to an extract of the Foreign Information System (FIS) containing FCC information return filings. The FIS extracts received were incomplete because information input into the FIS from Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472) had not been processed on a timely basis.
- II. Determined the actions the IRS is taking to address FCCs.
 - A. Determined the processing, identification, screening, and selection of FCC returns in the LMSB Division.
 - 1. Walked through the processing, identification, screening, and selection of FCC returns in the OSPC to construct a flowchart.
 - 2. Using the OSPC flowchart as a model, surveyed the BSPC, CSPC, and PSPC Examination Classification units to identify differences in classification processing.
 - 3. Reviewed the flowcharts from the four processing centers and identified a common control weakness in three of the four processing centers.

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4. Reviewed Part 3 of the Internal Revenue Manual (IRM) to determine how FCC returns are identified and delivered to Examination Classification units to be screened and to determine if any controls are established before the selected return is shipped to the local office.
5. Reviewed IRM Section 4.2.2.5.7 to determine the appropriate process to survey (i.e., make a decision not to examine) a return with an identified international issue previously selected during screening. Reviewed IRM 4.1.1 Chapter 1 through 4 of the International Procedures Handbook to determine criteria for not examining a return with international features, the referral criteria and procedures, referral instructions, and guidelines for evaluating the referral.
6. Interviewed LMSB Division officials concerning controls established to ensure that returns selected during screening are referred to International Examination groups for additional evaluation and possible examination and the reluctance of domestic managers and agents to refer returns with international issues.
7. Randomly selected a nationwide pilot sample¹ of 60 FCC returns from the Final Fiscal Year 1999 Non-Examined AIMS database that were closed as surveys before assignment (Disposal Code 31)² or surveys after assignment (Disposal Code 32).³ The pilot sample was taken to determine the exception rate of FCC returns selected in screening for mandatory referral that were not properly referred to an International Examination group. This was to be a preliminary step in the selection of a statistically valid attribute sample with a 95 percent confidence level; however, this sample was never selected. The population of 785 FCC returns was identified on the Non-Examined AIMS Database by linking an extract of the Statistics of Income (SOI) Corporate database for Tax Years (TY) 1993 through 1995 and TY 1997 that contained the FCC indicator. SOI data for TY 1996 was unavailable at the time this test was conducted but became available late in the audit.

¹ A pilot sample is used to test the data-gathering mechanisms and to get preliminary information for planning the main sampling scheme. This sampling technique is often used to determine the feasibility of conducting a larger sample.

² “Survey before assignment” is a decision not to examine a tax return made by the team manager prior to the tax return being assigned to a revenue agent for examination and without contact with the taxpayers or their representatives.

³ “Survey after assignment” is a decision not to examine a tax return after the tax return has been assigned to a revenue agent for examination and without contact with the taxpayers or their representatives. The decision is made after consideration by the revenue agent that examination of the tax return would result in no material change in tax liability, with the concurrence of the team manager.

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8. Obtained the assistance of an International Examiner revenue agent in the LMSB Division to evaluate the six returns identified in the pilot sample as not being properly referred, to determine the examination potential of the returns after additional evaluation.
- B. Determined if identification of second tier FCCs⁴ represented a significant problem with the examination of FCCs. We performed testing in the metropolitan Los Angeles area to identify potential unconsolidated second tier FCCs and determined our testing methods were ineffective at identifying if this potential problem exists, due to the unavailability of information.
- C. Reviewed the training material and other resources available to revenue agents to identify and examine issues specific to an FCC.
- D. Determined the effect that not processing all Forms 5472 could have on tax administration.
 1. Interviewed officials at the PSPC to determine the number of Forms 5472 submitted and processed in 1997, 1998, 1999, and 2000.
 2. Reviewed IRM Section 3.29.253 on returns processed into the FIS.
 3. Reviewed the Memorandum of Understanding executed in December 2000 to provide Full Time Equivalents to eliminate the backlog of unprocessed Information Return of U.S. Persons With Respect To Certain Foreign Corporations (Form 5471) and Forms 5472, and to keep current in the new processing year.
 4. Interviewed officials in the LMSB Division Strategy, Research, and Program Planning unit to determine the effect of not having timely processed Form 5472 returns.

⁴ A “second tier” FCC is a U.S. subsidiary domestic corporation controlled directly or indirectly by an FCC.

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Corporations for Examination Need Improvement**

Appendix II

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and
Corporate Programs)

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John J. Ochal, Auditor

William Tran, Auditor

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Corporations for Examination Need Improvement**

Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner N:DC
Deputy Commissioner, Large and Mid-Size Business Division LM
Deputy Commissioner, Small Business/Self-Employed Division S
Director, Strategy, Research, and Program Planning, Large and Mid-Size Business
Division LM:SR
Director, International, Large and Mid-Size Business Division LM:I
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
National Taxpayer Advocate TA
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Office of Management Controls N:CFO:F:M
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Audit Liaisons:
Commissioner, Large and Mid-Size Business Division LM
Commissioner, Small Business/Self-Employed Division S

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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

JUL 11 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Larry R. Langdon
Commissioner, Large and Mid-Size Business Division

SUBJECT:

Response to Draft Audit Report 2000-30-028, Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement

Thank you for the opportunity to review and comment on the subject draft report. We noted your recommendations for improving the controls over the identification and selection of Foreign Controlled Corporation (FCC) returns for examination.

Beginning last fiscal year, we took significant steps to reduce the backlog of Forms 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) and 5472 (Information Return of a 25 percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business). We will continue to find the necessary resources to eliminate the backlog by December 31, 2001. We have also established an International Classification Task Force to look at the entire classification and referral process to more effectively deliver international returns into the examination stream.

I agree with the findings and the recommendation in your draft audit report; however, I believe you should change the section of the report dealing with the report findings to more accurately show our progress in processing Forms 5471 and 5472:

- Draft Report Pages 4 – 6, Foreign Ownership Return Information is Not Processed Timely, Limiting Its Effective Use in Research and Planning Activities

This section of the draft report should show the following status of Forms 5471 and 5472 processing at the Philadelphia Service Center (PSC) to provide a more accurate and up to date picture of our progress:

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2

Form 5471:

<u>Tax Year</u>	<u>completed</u>	<u>Prior Backlog</u>	<u>Current Backlog</u>	<u>Total Number Processed</u>
1996	91,000			91,000
1997		40,000	20,000	30,000
1998	78,000	30,000	- 0-	78,000
1999		110,000	70,000	40,000

We will reduce all backlogs to zero by 12/31/01

Form 5472:

<u>Tax Year</u>	<u>completed</u>	<u>Prior Backlog</u>	<u>Current Backlog</u>	<u>Total Number Processed</u>
1996	90,000	90,000	-0-	90,000
1997		92,000	70,000	22,000
1998	98,000	-0-	-0-	98,000
1999	100,000	35,000	-0-	100,000

We will reduce all backlogs to zero by 12/31/01

Our comments to the report's findings and recommendation are as follows:

IDENTITY OF RECOMMENDATION/FINDING #1:

Recommendation:

The Commissioner, LMSB Division, in consultation with the Commissioner, SB/SE Division, should establish a uniform control at the submission processing centers over returns screened and selected by International Examiners for mandatory referral. The control should prevent the local domestic examination group from making a decision not to examine a selected return without the concurrence of an International examination group. This can be done by establishing a computer freeze code at the submission processing centers on the selected returns that can only be released by International examination groups once the return has been referred.

Finding:

Returns with International Features Are Not Always Referred to International Examination Groups Prior to Decisions Not to Examine.

Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement

3

ASSESSMENT OF CAUSE(S):

Non-referrals generally result from conflicting priorities between the domestic examiner groups and the international groups to whom the referral should be made. A situation might arise where we find significant domestic adjustments outweigh potential international issues, or the statute of limitation prohibits referral to International. Under these circumstances, the possibility exists that a referral will not be made, and an existing freeze code released by the international manager.

CORRECTIVE ACTIONS:

The LMSB International Classification Task Force has been looking at the non-referral problem and is considering various options to ensure timely referrals by domestic examiners to international groups. The Task Force is meeting at the end of June to finish its recommendations for improving the international classification, return delivery and referral procedures. Until then, we will emphasize using the freeze code to prevent domestic revenue agents from prematurely closing cases they should refer to the International Examination groups.

LMSB is also updating and revising the International Procedures Handbook and Examination Guidelines.

IMPLEMENTATION DATE:

PROPOSED COMPLETION DATE: June 30, 2002

RESPONSIBLE OFFICIAL(S):

Director, International (LMSB)

CORRECTIVE ACTION(S) MONITORING PLAN:

We will work with the LMSB International Territory Managers to facilitate closer coordination with SBSE and LMSB domestic examination managers and LMSB international managers to ensure timely referrals of international cases and their use of an interim freeze code. This will address the problem of early closures until the LMSB International Classification Task Force develops and implements its final procedures.

IDENTITY OF FINDING:

Foreign Ownership Return Information Is Not Processed Timely, Limiting Its Effective Use in Research and Planning Activities

Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement

4

ASSESSMENT OF CAUSE(S):

PSC was not properly staffed to handle the volume of Forms 5471 and 5472 prior to the current reorganization of IRS. They had been provided with 22 Full Time Equivalent (FTE) staff years by the service center organization; however, this proved to be insufficient to solve the problem.

CORRECTIVE ACTIONS:

LMSB established a Memorandum of Understanding (MOU) with PSC early this fiscal year to allocate 70.4 additional temporary staff years to enable PSC to process the backlog of Forms 5471 and 5472. This MOU expires December 31, 2001. PSC expects to eliminate the backlog before the MOU expires. LMSB is drafting a new MOU to allocate the staffing needed to process the forms. We expect the volume of paper submissions of Form 5471 and 5472 will decrease and processing will improve as electronic corporate filing becomes operational.

IMPLEMENTATION DATE:

COMPLETED: December 31, 2000

CORRECTIVE ACTION (S) MONITORING PLAN: N/A

We enjoyed working with your staff, and we appreciate the constructive assistance this audit provided. If you have any questions, please contact Carol Dunahoo, Director, International at (202) 674-1900.